How Canada Is Responding to American Mercantilism

As countries grapple with the US's more mercantilist trade policy, Canada offers a window into how different economies may respond to these pressures.

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In previous research, we wrote extensively about President Trump's embrace of modern mercantilism. **This reorientation of trade policy, not just with the US's traditional adversaries but with some of its closest allies, has been disruptive to existing economic relationships, and none more so or more abruptly than Canada given its outsize exposure to the US.**

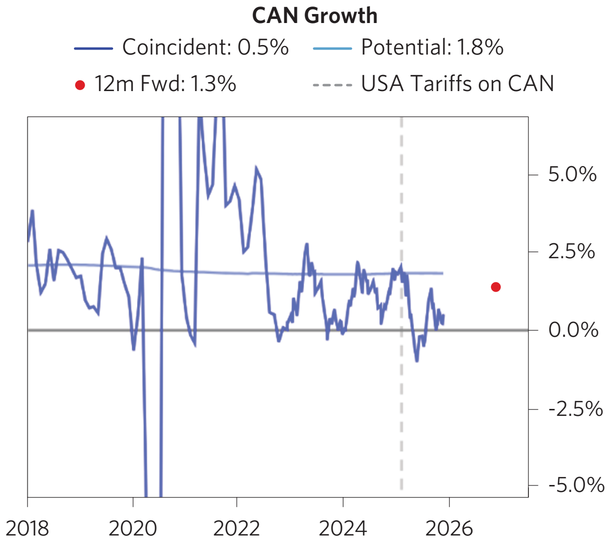
Before US tariffs were introduced, exports accounted for roughly one-third of Canada's national income, with about 75% of those exports going to the US. The shift in US policy created a significant domestic economic shock—with tariffs as high as 35% on certain non-USMCA-compliant goods and the future of the USMCA itself highly uncertain, Canadian exports have plummeted. Business confidence and investment fell accordingly, the labor market continued to soften, and Canadian GDP growth fell into contraction in Q2 2025.

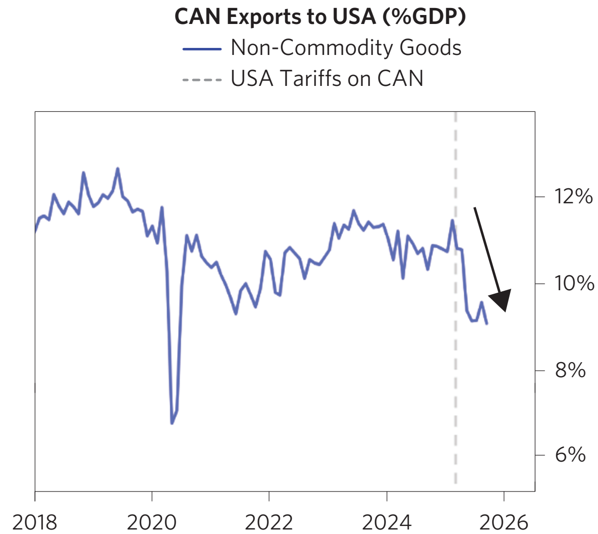
Canada's initial response was to impose counter-tariffs on US goods. But they were quickly rolled back as the tit-for-tat approach proved self-defeating when met with US escalation. With little leverage to force US policy retracement, Canada has had to look inward and rapidly adapt. So far, the results are too early to extrapolate but are nonetheless promising, with signs of stabilization if not growth. **Looking at what Canada has chosen to do from a position of extreme economic dependence offers a road map for countries that are perhaps less threatened but that, as a result, have been slower to substantively react to the new world they find themselves in.**

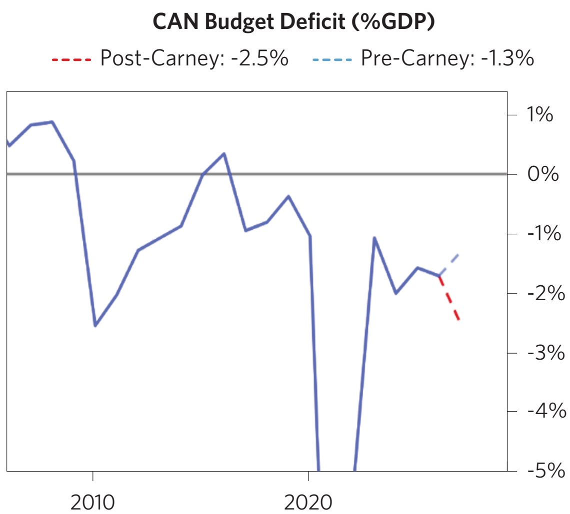
More specifically, Canadian policy makers have responded with a three-pronged approach aimed at reducing dependence on the US and driving economic growth:

1. They are **diversifying trade away from the US** with an explicit goal of doubling non-US exports over the next 10 years. They are pushing to expand partnerships with countries in Asia and Europe, signing new free-trade agreements, and standing up new government agencies to promote Canadian goods outside of the US.
2. They are pursuing **rapid fiscal expansion and deregulation**, planning to spend billions of new dollars on infrastructure and defense projects, mandating the federal government to procure from domestic producers, fast-tracking projects of national importance, and decreasing business and personal income taxes to stimulate growth, among other policies.
3. The Bank of Canada has continued to run **loose and more proactive monetary policy** despite an acceleration in underlying inflation measures, aiming to make exports more competitive, front-load credit creation, and sustain the accommodative conditions for a rebound in productivity and growth.

These efforts are starting to bear fruit—new orders are rising, residential construction projects are picking up, and the labor market is showing initial signs of stabilization. Rising asset values, stimulative government policies, and solid wage gains have further helped household activity continue to grow. To be certain, Canada has unique economic advantages, most notably a stable of natural resources and established commodity production ripe for export diversion. Canada's path is fairly unique and has necessitated a particularly strong fiscal response, but, elsewhere, the disruption from modern mercantilism also pushes in the direction of higher deficits and **a higher supply of government debt for markets to absorb**.



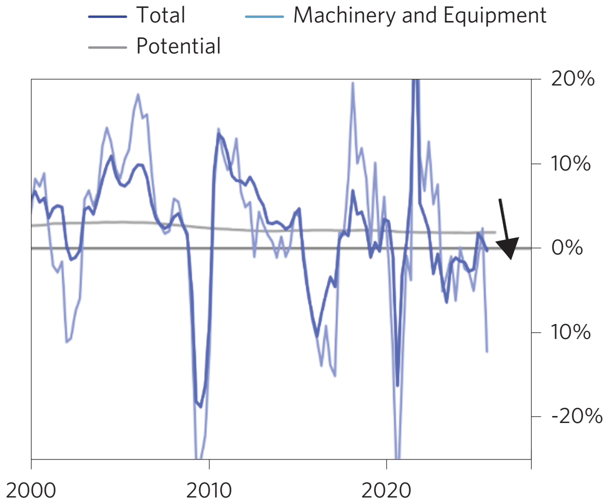




Higher US Tariffs and Elevated Uncertainty Weakened Canadian Conditions

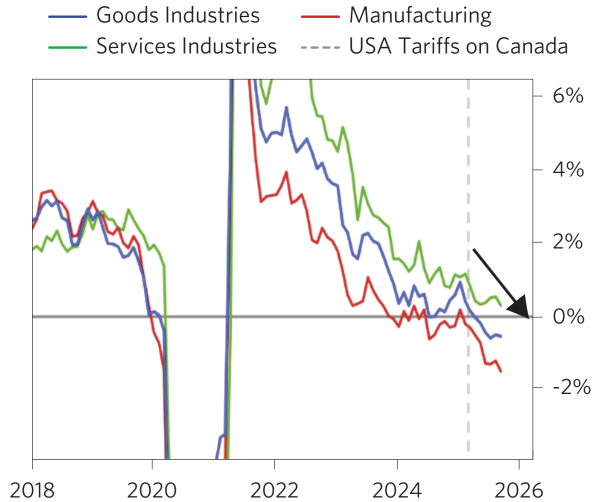
When a highly globally exposed economy like Canada faces serious trade uncertainty from its closest trade partner, the resulting risk of a rapid tightening in external demand tends to pull back domestic investment. In Canada—where the US tariff rate on Canadian goods has risen to its highest level since the Great Depression—exports have contracted and business investment has weakened as firms delayed or canceled projects. Uncertainty surrounding USMCA negotiations has further compounded this drag, as the agreement's first joint review is not scheduled until July 2026. This dynamic continues to weigh on an already soft Canadian labor market, particularly in the most trade-exposed sectors like auto manufacturing and steel/aluminum production, where firms had to either reduce head count or substantially slow hiring.

CAN Real Business Investment (Y/Y)



Businesses delayed planned investments...

Employment Level (12m Chg)



...weighing on the already soft labor market conditions

Canada's Three-Part Response

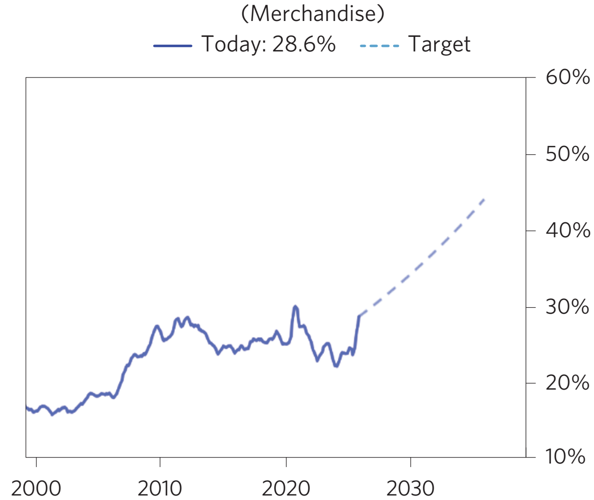
1. Diversifying Trade Away from the US

After President Trump recently threatened to impose an additional 10% tariff hike on Canadian exports following an Ontario advertisement featuring Ronald Reagan criticizing tariffs, and amid continued uncertainty over the future of USMCA, Canadian policy makers announced a formal commitment to double non-US exports over the next decade. In a speech on October 22, Prime Minister Mark Carney outlined Canada's strategic response to the US-driven trade uncertainty as follows:

"**That decades-long process of an ever-closer economic relationship between Canada and the United States is now over**...Many of our former strengths...based on close ties to America have become our vulnerabilities...**Our goal for Canada is to double our non-US exports over the course of the next decade**, generating more than $300 billion in trade."

CAN Share of Non-USA Exports

(Merchandise)

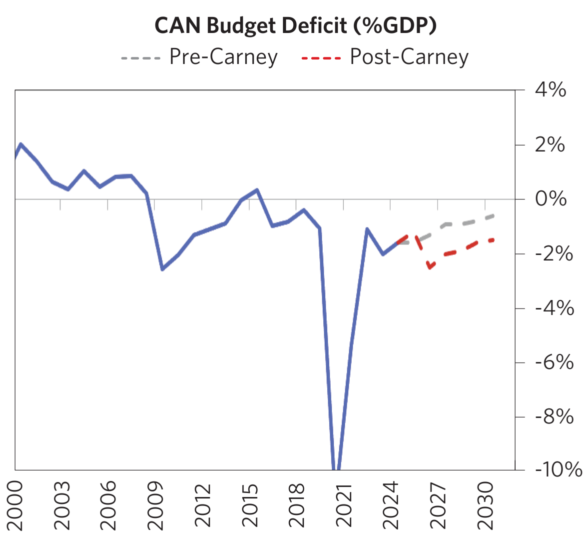


Officially named the **Trade Diversification Strategy**, the plan expands the government's flagship Trade Impact Program fivefold to C$25 billion, increasing access to credit insurance and foreign exchange guarantees for exporters. On the infrastructure front, Canada will establish the C$5 billion Trade Diversification Corridors Fund and the C$1 billion Arctic Infrastructure Fund to invest in ports, rail lines, and other projects aimed at improving the efficiency of export flows across the country. The strategy also creates a new strategic exports office to coordinate senior-level trade engagements, focusing on strengthening ties with partners in the Indo-Pacific and Europe.

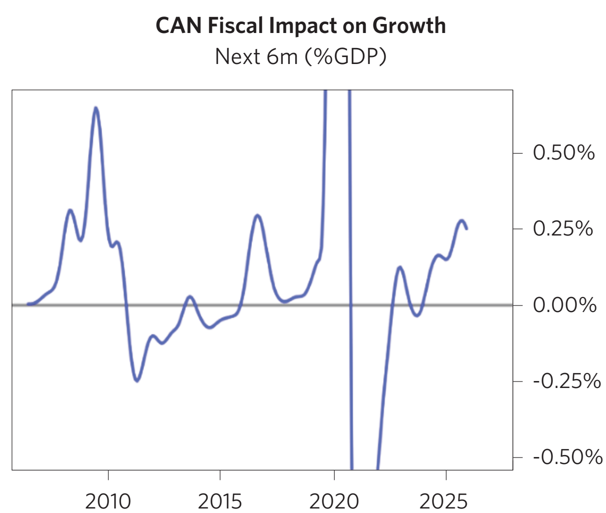
Legislation has been matched with outreach. In October, Carney embarked on an official trip to Asia to deepen trade and security partnerships, building on Canada's first-ever bilateral trade agreement with an ASEAN member, Indonesia, under which the Indonesian government eliminated tariffs on 95% of current Canadian exports. Carney also initiated new free-trade agreement conversations with Thailand and the Philippines and held a widely reported 40-minute conversation with President Xi Jinping following earlier tariff escalations between the two countries. Carney described the meeting as a "turning point" in China-Canada relations, while President Xi stated that, "China is willing to work with Canada to push...relations back onto a healthy, stable, and sustainable correct track."

2. Proactive Government Spending Prioritizing Self-Sufficiency

In today's modern mercantilist era, countries seeking to reduce dependence on the US have increasingly turned to deficit-financed spending to build up domestic industry. During the 2025 federal elections, a central pillar of Carney's campaign was his mercantilist "Canada Strong" program, which promised to boost domestic investment through significant new infrastructure and defense spending without cutting social benefits or raising taxes. On November 4, 2025, the government introduced the **Canada Strong Budget 2025**, formalizing a **C$20.1 billion (0.6% of GDP) fiscal expansion** for the 2025-26 fiscal year. This was in addition to previously announced and enacted emergency measures following Carney's election, bringing the total deficit for fiscal year 2025-26 to **C$78 billion (2.5% of GDP)**—levels last seen in the aftermath of the global financial crisis. This surge in public borrowing in Canada adds to the **broader trend of elevated global duration supply**.



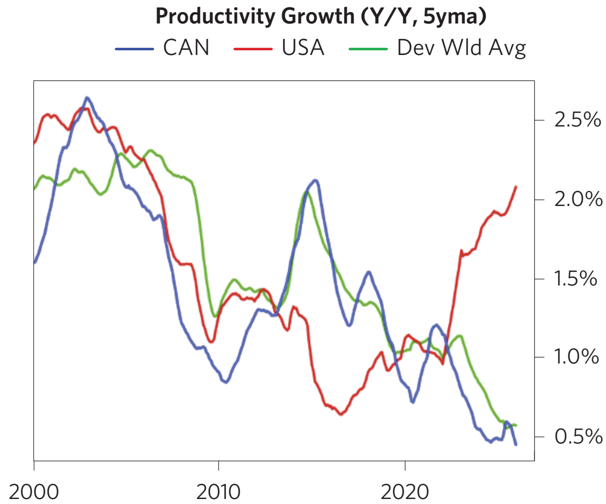
Canada's 2025 budget expands the overall budget deficit significantly in 2025-26...



...resulting in a +0.25% boost to Canadian real GDP growth over the next six months

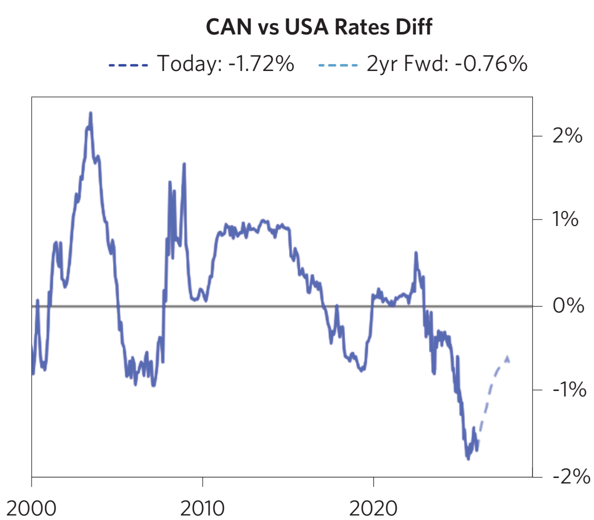
While the scope of fiscal easing of the Carney administration had been well-telegraphed on the campaign trail, the composition of policies and the tone around them have leaned even more mercantilist than anticipated. The budget's stated ambition to "protect and transform our strategic industries, build a stronger economy, and invest in ourselves" was reflected in several flagship initiatives, including a 5% of GDP 2035 defense spending target (compared with 2% this year), a Buy Canadian Policy requiring federal procurement to prioritize domestic producers, and a productivity super-deduction allowing businesses to take a 100% tax deduction for manufacturing machinery and equipment, R&D capital expenditures, and spending on data network infrastructure.

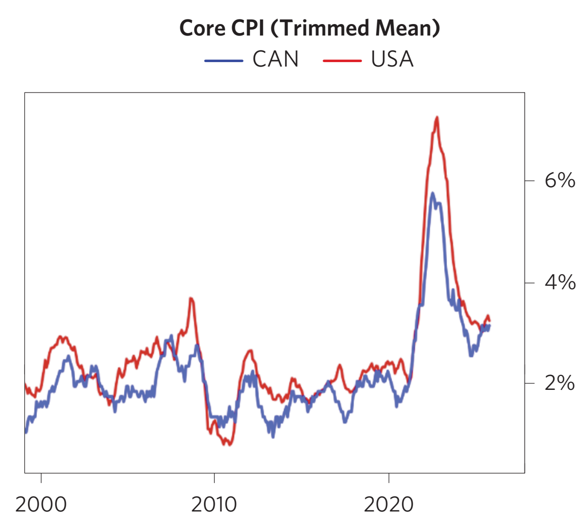
Among other objectives, the Carney administration also views proactive fiscal policy as a tool to drive convergence with US economic performance—particularly on the productivity front, where Canada has lagged since COVID. Weak productivity growth has reinforced weak domestic investment dynamics, slowed real wage growth, kept GDP growth subdued, and limited Canada's fiscal capacity. While higher public investment may provide a cyclical lift, a structural improvement in productivity will be required for persistent impact.



3. Continuing to Run Easier Monetary Policy

Having already entered an easing cycle last year in response to slowing domestic and global growth, the Bank of Canada has elected to continue to run an even more accommodative policy stance as tariff volatility and renewed trade tensions further weighed on domestic conditions. This largely front-loaded easing cycle in Canada resulted in historically significantly easier policy than that of the US. However, with core inflation already showing acceleration toward the upper bound of the target range, and the forthcoming fiscal expansion likely to add further inflationary pressure, there is a natural limit to how much easier Canadian policy can run from here. This is the challenge faced by central banks as governments adopt mercantilist fiscal policies—and why fiscal is likely to be needed to shoulder much of the economic readjustment burden going forward. But the Bank of Canada seems comfortable with remaining accommodative until its hand is otherwise forced.

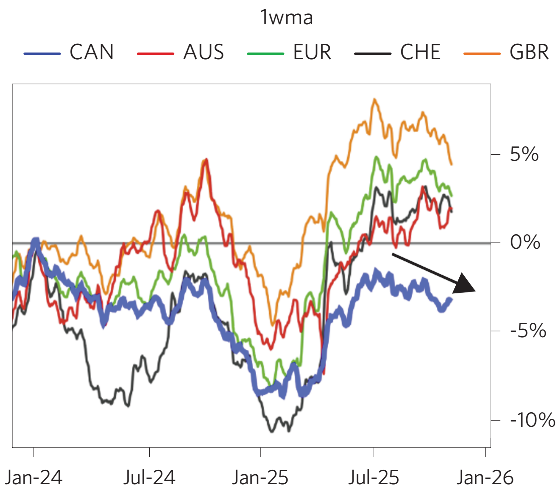




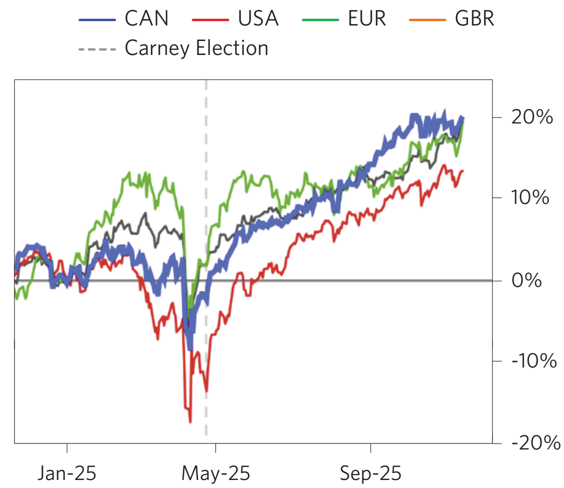
From the Bank of Canada's perspective, the trade-off of maintaining an easier policy versus the US is acceptable at this stage, as a softer Canadian dollar limits appreciation pressures in a weak-USD environment and marginally improves the competitiveness of Canadian exports. At the same time, easier monetary policy helps reignite the credit creation channel, especially through 1) mortgages, where Canada's shorter reset terms and higher share of variable rate loans transmit easing more quickly, and 2) through more SME borrowing, which feeds into job creation and household spending.

With accommodative monetary policy and expansionary fiscal measures working together to re-energize domestic growth, Canadian investors—heavily overallocated to US assets—now face stronger incentives to repatriate capital and to invest at home. As Canada attempts to close the gap in economic conditions with the US, market performance has already started reflecting early signs of progress, leading to Canadian equities meaningfully outperforming their US counterparts year-to-date.

Real FX vs USD (Idx Jan 2024)



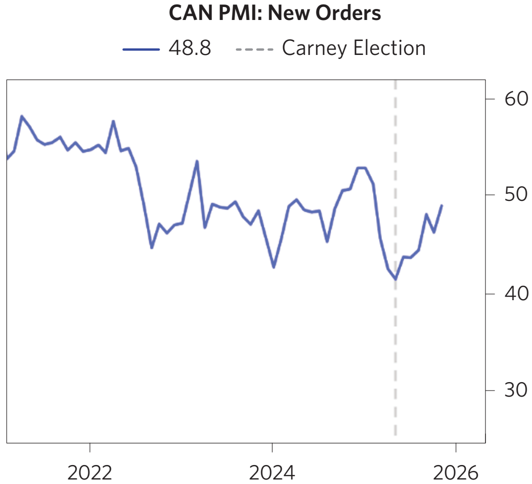
Equity Idx Excess Returns (YTD)



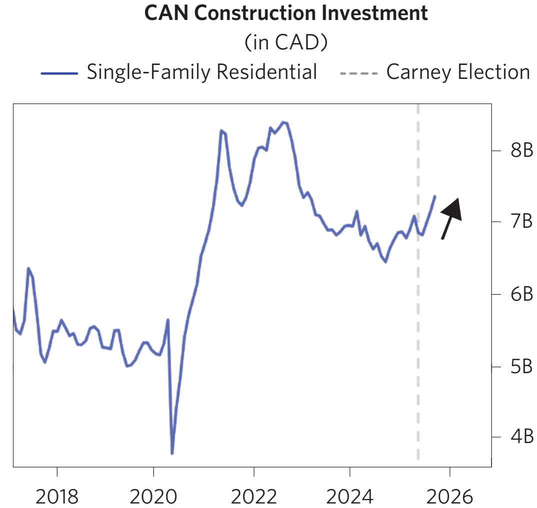
Early Signs of Stabilization Are Starting to Become Visible

Recent macroeconomic data shows early signs that Carney's win and the government's proactive policy response are beginning to bear fruit: manufacturing orders are rising, residential construction activity is inflecting positive, and even labor market indicators are starting to show resilience after months of softness. A rally in domestic asset prices, combined with wage gains, has been supporting household demand. As the bulk of government spending and stimulative measures take effect over the next six months, there is room for further improvement in high-frequency indicators of domestic growth.

CAN PMI: New Orders



CAN Construction Investment



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